COMMONWEALTH OF VIRGINIA, ex rel.

GEORGE M. HUDGINS, et al.

v. **CASE NO. PUE960133**

SYDNOR HYDRODYNAMICS, INC.

REPORT OF DEBORAH V. ELLENBERG, CHIEF HEARING EXAMINER

October 7, 1998

On July 24, 1996, the First Colony Civic Association ("the Association") filed a petition requesting the Commission to determine if the rates of Sydnor Hydrodynamics, Inc. ("Sydnor" or the "Company") for service through the First Colony water system in James City County, Virginia were reasonable and its service adequate. The petition was signed by approximately 85% of the system customers.

By order dated September 23, 1996, the Commission established this case and ordered the Company to file certain financial data for the First Colony system for the year ending December 31, 1995. The Company responded with a Motion to Modify the Commission's Preliminary Order, stating that it did not keep its books in a manner that would present a realistic picture of the First Colony system's revenues and costs. It explained that Sydnor's books and records are generally aggregated for all of its nonregulated water operations. Therefore, the Company sought permission to adopt temporary accounting and bookkeeping mechanisms on a going-forward basis for the succeeding 12-month period. The Company also objected to any attempt to convert its rates to interim and subject to refund.

On November 1, 1996, the Division of Consumer Counsel, Office of the Attorney General of Virginia ("Consumer Counsel") requested a hearing. Staff joined in that request on February 13, 1997. On March 31, 1997, the Commission entered a Consent Order reciting the agreement of Sydnor, Staff and the Consumer Counsel to make rates interim, and subject to refund effective April 1, 1997, pending further order of the Commission.

On April 15, 1997, the Commission issued an order scheduling a hearing and requiring the Company to implement a cost tracking procedure on a going-forward basis. The Commission also required the Company to submit financial data for the First Colony system based on a six-month period ending June 30, 1997.

A hearing to receive evidence on the rates and service for the First Colony system was convened with John D. Sharer, Esquire, appearing on behalf of the Company and Marta B. Curtis, Esquire, appearing on behalf of Staff. Three public witnesses also appeared to offer their statements. A transcript of the hearing is filed with this Report. Post-hearing briefs were filed on January 5, 1998.

SUMMARY OF THE RECORD

Sydnor owns and operates seven regulated water utilities and approximately 91 unregulated companies in Virginia including the First Colony system.[1] Sydnor is also engaged in several other aspects of the development of water systems, such as well drilling, pump sales, and system construction.[2]

Sydnor serves approximately 255 residential customers in the First Colony Subdivision in James City County, Virginia.[3] Sydnor contracted with First Land Corporation, the original developer of the subdivision, to provide service to the First Colony community on July 15, 1963.[4] The contract established the original water rates and authorizes Sydnor to increase rates periodically in accordance with a cost of living escalator tied to the increase in the Consumer Price Index published by the Bureau of Labor Statistics.[5]

Sydnor has increased its rates four times since 1991.[6] Sydnor's current rates which have been challenged in this case include:

- A bimonthly minimum charge of $33 which includes 4,000 gallons of usage per month, and

- A charge for usage in excess of 4,000 gallons per month or $4.125 per 1,000 gallons of water.[7]

Approximately 85% of the customers of the First Colony system signed a petition requesting the Commission to schedule a hearing to investigate the rates and quality of water service being provided by the Company. Three of those customers offered testimony as public witnesses. George M. Hudgins, Jr. expressed concern with service quality, notably extended outages. He asked the Commission to accept Staff's recommendations and protect the consumers' interests.[8] James Haltiner also offered testimony. He stated that:

> the motivation for our petition to the Commission was years of frustration in communicating with the Company with regard to quality of service, with regard to health concerns about water quality

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[1]Ex. MRDB-9, at 2.

[2]Id.; Tr. 37.

[3]Exs. JLR-1, at 1-2; JAS-8, at 3-4; MRDB-9, at 3.

[4]Exs. JLR-1, at 2; JLR-2.

[5]Exs. JLR-1, at 2 and JLR-2, at 7.

[6]Ex. JAS-8, at 4-5.

[7]Id.

[8]Tr. 20-22.

> and with regard to the very high rates relative to our neighbors in James City County and the City of Williamsburg.
>
> . . . .
>
> I have great confidence in Mr. Mark DeBruhl's analysis from the Staff to fairly portray the Company's profitability based on the availability. He concluded, as we suspected, that the Company is quite profitable, with a return on rate base of. . . approximately 53 percent.[9]

Mr. Haltiner also expressed skepticism with Sydnor's allocations among its many systems.[10] Finally, John B. Hewett testified. Mr. Hewett is a customer and president of the Greater First Colony Area Civic Association which serves 494 homes in the First Colony subdivision, including the 255 homes served by Sydnor. He stated that "[t]he issues are reliable service at reasonable rates with attention to maintaining good customer relations."[11]

The Company offered the testimony of Jesse L. Royall, Jr. and Burnice C. Dooley, and first asserts that the Commission does not have jurisdiction over it. The Company also argues, however, that its rates are reasonable. The Company asserts that Sydnor will realize an annual loss of $1,033 under current rates for the First Colony system.[12] It further argues that an annual increase of $20,747 is justified and proposes to add two temporary surcharges to recover the costs of this proceeding and those related to tracking and reporting First Colony system expenses.[13] The first surcharge, which is proposed to be $8.50 bimonthly, was designed to recover rate case expenses over a three-year period.[14] The second surcharge, which is proposed to be $5.06, was designed to recover the costs of separately tracking system expenses, and would remain in effect as long as the Commission retains jurisdiction over the First Colony system operations.[15]

Staff offered the testimony of John A. Stevens and Mark R. DeBruhl. At the hearing the Staff accepted several of the Company's accounting adjustments, however several adjustments which Staff proposed remained in controversy. Those adjustments include rate case expenses, expenses related to the controller's time tracking First Colony system costs, salary expenses, leak expenses, uncollectible expenses, meter expenses, and other miscellaneous expenses. Staff also takes exception to the proposed surcharges. Staff determined that the annual net operating income for the First Colony system based on the six-month test period is $8,366 which yields a 52.96% return on a $15,796 rate base.[16] Staff testified that the Company needs only $3,713 in net operating

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[9]Tr. 23-24.

[10]Id.

[11]Tr. 29.

[12]Ex. BCD-4, at 2.

[13]Id.

[14]Id. at 5-6.

[15]Id.

[16]Ex. MRDB-10, at 5 and Rate of Return Statement - Adjusted.

income which would result in a 23.51% return on a rate base of $15,796.[17] Staff recommends that the Company's annual operating revenues be reduced by $7,500, applied equally to the minimum and usage charges.[18]

In addressing quality of service concerns, Staff witness Stevens offered testimony that the Company has reduced the number of leaks on the system, and a reduction in construction activity should further reduce leaks and line breaks.[19] However, Staff recommended that the Company monitor its leaks and line breaks which result in service interruption, and maintain a detailed record. Mr. Stevens also testified that the Company's procedures for responding to service problems are adequate with one exception.[20] The telephone number to report problems after hours is not a toll free number. Staff recommends that the Company be directed to make a toll free number available for customers to report problems after normal business hours.[21] Finally, Staff recommends that the Commission retain jurisdiction over this system for a period of two years.[22]

DISCUSSION

A number of issues remained in controversy by the end of the hearing. First, the Company challenged the Commission's jurisdiction. It argues that the legislative attempt to extend Commission jurisdiction over unregulated water companies beyond that established in Chapter 10.2 of Title 56 of the Code of Virginia is unconstitutional. It also argues that any attempt to adjust its rates which were set pursuant to a private contract would violate the Contract Clause of the Constitutions of the United States and of Virginia. Further, the Company argues that any effort to reduce its rates would result in an unconstitutional taking without due process or just compensation.

The Company also argues that even if the Commission exercises jurisdiction, its existing rates are just and reasonable, and it is entitled to special surcharges to recover the additional costs of regulation.

Staff takes exception to the Company's position. Staff asserts that the Commission has clear authority to assert jurisdiction over the Company and proposes several adjustments to determine the Company's revenue requirement. Staff also recommends the Commission retain jurisdiction over the First Colony system for two years.

1. The Commission has clear authority to exercise jurisdiction over Sydnor's rates and service.

[17] Id.

[18] Exs. MRDB-10, at 5; JAS-8, at 7.

[19] Ex. JAS-8, at 10.

[20] Id. at 12.

[21] Id. at 16.

[22] Id.

a. Virginia Code § 13.1-620 G authorizes the Commission to order Sydnor to make improvements or rate changes as are just and reasonable.

The Company challenges the Commission's jurisdiction in several respects. First, the Company argues that the Commission does not have jurisdiction over Sydnor because Sydnor is not a public service corporation. It argues that the Commission may only assert the jurisdiction provided in Chapter 10.2 of Title 56 of the Virginia Code.

That chapter defines a limited scope of Commission authority to address disputes between certain water and sewerage systems not regulated as public utilities and their customers. There, section 56.265.11 provides:

> If fifty or more of the subscribers, but not more than one from any one household, who have contracts to purchase water from a water system or for sewerage service from a sewerage system file with the Commission a petition alleging that the service furnished by the system is inadequate and ought to be improved, the Commission shall after notice to the operators of such system investigate the complaint and formulate an opinion whether in the light of the successful performance of sewerage or water systems of similar design and purpose, the system is capable of serving the reasonable domestic needs of the persons or properties served.

Moreover, the Virginia Supreme Court found that section 56-265.11:

> does not empower the Commission to determine and adjudicate the rights and liabilities of parties to contracts between a privately owned water system and its consumer connectors, or to enforce the provisions of such contracts. It does not authorize the Commission to formulate an opinion as to whether a water system has complied with its contracts with the customers. The question whether a contract has been breached is for the courts to determine. (citations omitted). . . .The jurisdiction of the Commission under Chapter 10.2 of Title 56 is confined to the issue of the capability of the water system under investigation and not to the question whether the water system has fulfilled its contracts with its consumer connectors.[23]

[23] *Sydnor Pump & Well Co. v. Taylor*, 201 Va. 311, 317 (1959).

Section 56-265.12 goes on to define what can be done with a Commission opinion on the quality of service:

> The opinion of the Commission shall be furnished in writing to the petitioners and to the owners of the water or sewerage system and shall be admissible in evidence in any proceedings concerning contracts between such water sewerage system and its subscribers together with any other evidence which may be offered by either litigant.

The Company argues that Chapter 10.2 of Title 56 is the only Code section that can be applied to Sydnor.[24] To the contrary, however, all applicable law must be considered, including Virginia Code section 13.1-620 G which expands the Commission's authority in this area.

Section 13.1-620 of the Code first establishes restrictions on corporations that provide special kinds of business. That section generally provides that corporations offering public utility services, including water or sewer companies serving more than 50 customers, must incorporate as public service corporations. Water or sewer corporations incorporated before January 1, 1970, however, are exempt from that requirement and need not incorporate as a public service company.[25] Thus Sydnor, which was incorporated prior to January 1, 1970, is not required to incorporate as a public service corporation.

In 1974, that section was further amended, however, to provide that otherwise unregulated water or sewer companies may be subject to the Commission's jurisdiction in specific circumstances where regulatory intervention is requested and warranted.[26] Code section 13.1-620 G provides that:

> G. A water or sewer company that proposes to serve more than fifty customers shall incorporate as a public service company. A water or sewer company shall not serve more than fifty customers unless its articles of incorporation state that the corporation is to conduct business as a public service company. The two preceding sentences shall not apply to a water or sewer company incorporated before and operating a water or sewer system on January 1, 1970; however, <u>as to any water or sewer system serving more than fifty customers, upon application to the Commission by a majority of the customers</u> or by the company, <u>a hearing may be held</u> after thirty days' notice to the company and the system's customers or a majority thereof, <u>and the Commission may order such, if any, improvements or rate changes or both as are just and reasonable</u>. Upon ordering into effect any rate changes or improvements found to be just and reasonable, the water or sewer system shall remain subject to the Commission's regulatory authority in the same manner as a public utility for such reasonable period as the Commission may direct.

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[24]Company Brief at 12.

[25]Virginia Code § 13.1-620 G.

[26]1974 Va. Acts of Assembly ch. 285.

Emphasis added.

Section 13.1-620 G therefore clearly expands the scope of authority granted to the Commission in the Virginia Code beyond that discussed by the Court in the 1959 Sydnor case to include jurisdiction over rates and to correct service problems in specific circumstances.

In 1975, the Commission exercised that jurisdiction in the *Application of Oak Hill Water Company, Inc*., Case No. 19475, 1975 S.C.C. Ann. Rep. 206. Therein, the Commission found that Section 13.1-50[27] of the Virginia Code gave the Commission the requisite jurisdiction to entertain the application of the Oak Hill Water Company, Inc. The Commission held that "[i]n determining reasonable rates and charges for the water and sewerage services of the applicant, the Commission is exercising the lawful police power of the State, which power takes precedence over the restrictive covenant contained in certain Deeds of Bargain and Sale held by the individual protestants, which restrictive covenant prescribes the rates and charges for water and sewerage services. . . ".[28]

In 1976, in a case very comparable to the pending case, the Commission exercised jurisdiction over another water company, Broadview Water Works, Inc. upon the petition of a majority of its customers.[29] In that case, the company was not a public service corporation, but the Commission exercised jurisdiction pursuant to § 13.1-50 to require Broadview to reduce its rates and implement several service quality initiatives.[30] The hearing examiner found that "[b]y virtue of Code § 13.1-50, 'the Commission may order such. . .improvements or rate changes or both as are just and reasonable.' This authority is tantamount to that which the Commission exercises over public service companies generally. Consequently, Broadview should be treated as any other regulated water company."[31] The statutory language and Commission precedent clearly support a finding that the Commission has the authority to exercise jurisdiction over Sydnor.

Sydnor next argues that the 1974 amendment to Code § 13.1-620 G is unconstitutional and is in conflict with the authority granted in Va. Code § 56.265-11. I disagree. Certainly Section 13.1-620 G expands the scope of the authority over unregulated water or sewer companies, but it does not conflict with other provisions. Previously, the Commission could only express an opinion on the ability of a company to provide service. After the 1974 amendment, the Commission can now exercise limited jurisdiction over such companies when specific circumstances warrant such intervention. The general rule of in pari materia provides that statutes which relate to the same subject should be read and applied together.[32]

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[27]Virginia Code § 13.1-620 G was formerly codified as § 13.1-50.

[28]*Application of Oak Hill Water Co*., Case No. 19475, 1975 S.C.C. Ann. Rep. 206, at 207.

[29]*Commonwealth of Virginia, ex rel. State Corporation Commission v. Broadview Water Works, Inc.*, Case No. 19534 (PUE790018), 1976 S.C.C. Ann. Rep. 107.

[30]Id.

[31]Hearing Examiner Report at 6 (DCC No. 791210160) (October 15, 1976).

[32]17 M.J. Statutes § 40 (1994).

The applicable Code sections are clear and unambiguous and can be read harmoniously; however, even if the Code sections were found to be in conflict, the later provisions of 13.1-620 G would prevail in this case. As a general rule of "statutory construction, if several statutory provisions cannot be harmonized, controlling effect must be given to the last enactment of the legislature."[33] The language in § 13.1-620 G which Sydnor argues is in conflict with the provisions of Chapter 10.2 of Title 56 was adopted in 1974, subsequent to § 56-265.11.

b. The Contract Clauses of the Constitutions of the United States and Virginia do not render the exercise of jurisdiction over Sydnor in this case unconstitutional.

The Company also asserts that any attempt by the Commission to adjust its rates would violate the Contract Clause of the Constitution of Virginia which provides "that the General Assembly shall not pass any law impairing the obligation of contracts. . . ."[34] The Federal Constitution has a similar provision providing that "[n]o state shall. . .pass any. . .law impairing the obligation of contracts. . . ."[35]

Specifically, the Company argues that assertion of Commission jurisdiction pursuant to Va. Code § 13.1-620 G would be an unconstitutional impairment of the July 15, 1963, contract between Sydnor and the original developer of the First Colony Subdivision. The Company cites a three-part test used by the U. S. Supreme Court to determine if a state law contravenes the Contract Clause.[36] First, the Court held that a threshold determination must be made concerning whether a state law has impaired a contractual obligation. Second, it must be determined if the impairment is substantial; and third, it must be determined if a legitimate public purpose justifies the impairment. Thus, there must be a contract which has been substantially impaired and there must be no legitimate public purpose justifying the impairment, for a violation of the Contract Clause to exist.[37] Sydnor argues that it was not a regulated public utility when it entered into the July 1963 contract, and therefore an attempt to bring it under the Commission's rate jurisdiction pursuant to the 1974 amendment to Code § 13.1-620 G would vitiate and undermine the contracting parties' belief that their relationship would be governed by a private contract. The Company asserts that § 13.1-620 G, as applied to Sydnor, unconstitutionally impairs its rights under the July 15, 1963, contract. Moreover, Sydnor argues that impairment is substantial, and further, that no public purpose justifies the impairment.

The record is clear that a contract exists between Sydnor and the original developer of the subdivision, and further that the contract may be affected if the Commission exercises jurisdiction, albeit limited, over Sydnor. However, public policy interests warrant the Commission exercising jurisdiction to assure that an essential service, here, water and sewer service, is being reasonably provided at fair rates. As the Commission did in both the *Oak Hill Water Company* and *Broadview*

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[33] Id. at 400.

[34] Virginia Const. art. 1, § 11.

[35] Tr. 12; U. S. Const. art. 1, § 10.

[36] Company Brief at 7, citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244-45 (1978); *United States Trust Co. v. New Jersey*, 431 U.S. 1, 21 (1977); *City of Charleston v. Public Service Commission of West Virginia*, 57 F.3d 385, 391 (4th Cir.), cert. denied, 116 S. Ct. 474 (1995).

[37] Id.

Water Works cases, supra, it should exercise jurisdiction over Sydnor to review rates and services, and order changes, if necessary. No Contract Clause violation exists in this case.

c. Commission action to reduce Sydnor's rates if supported by a finding that the current rate level is unjust and unreasonable, would not constitute an unconstitutional taking of the Company's earnings without due process.

The Company next asserts that if the Commission adopts the Staff's recommendations in this case, it would result in an unconstitutional taking of the Company's earnings without due process. The Company argues that denying recovery of the regulatory costs necessarily incurred to comply with Commission imposed mandates would be an unconstitutional regulatory taking of Sydnor's property without just compensation in violation of the Fifth and Fourteenth Amendments to the United States Constitution.[38]

The Fifth and Fourteenth Amendments together provide that private property may not be taken by the state government without just compensation.[39] The U. S. Supreme Court has defined taking and specifically cited several factors that are significant:

> In engaging in these essentially ad hoc, factual inquiries, the Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. So, too, is the character of the governmental action.[40]

Moreover, the Supreme Court specifically has held that utility rate regulation can result in an improper taking if rates are set at a level found to be unjust or confiscatory.[41] The Supreme Court has also held that:

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry. . .is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[42]

The Company argues that the Commission's assertion of jurisdiction was sudden, unanticipated, and imposed a retroactive obligation. The Company also argues that the Commission's action would interfere with distinct investment-backed expectations. The Company argues that its interest in retaining its unregulated status and its property interest in its 1963 contract

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[38]Company Brief at 38.

[39]U.S. Const. amend. V, cl. 4, and amend. XIV, cl. 3.

[40]*Penn Central Transportation Co. v. City of New York,* 438 U.S. 104, 124 (1978) (citations omitted).

[41]*Duquesne Light Co. v. Barasch,* 488 U.S. 299, 307 (1989).

[42]*Federal Power Commission v. Hope Natural Gas Co*., 320 U.S. 591, 602 (1943).

"substantially outweigh the Commission's interest in protecting First Colony's customers."[43] The Company argues that the present case satisfies all parts of the takings test articulated in the *Penn Central* case.

Here, in my opinion, Sydnor's interests do not outweigh the public interest considerations. The First Colony community is entitled to reasonable water and sewer service at just rates. An improper taking does not result if the Commission sets rates at a reasonable level based on the record developed herein. The Company received reasonable notice and has had ample opportunity to, and did, participate in the hearing in this case to develop its position on the issues raised by the Staff and the public witnesses. Certainly, no process was denied. The record supports a finding that the rates recommended herein are reasonable. Thus no improper taking is suggested.

2. Lower rates designed to generate an annual revenue requirement of $78,995 are just and reasonable.

Staff, in supplemental testimony filed on November 4, 1997, accepted the Company's adjustments for vacation expense for hourly employees, insurance benefits expense, telephone equipment expense, computer services, building maintenance and repair expense (other than $31 for roof repair) and office equipment maintenance and repair.[44] Many other adjustments affecting rates, however, remained in controversy.

a. Rate Case Expense

Staff and the Company differ on the proper level of rate case expenses, the amortization period for such expenses, and the rate design mechanism to be used to recover those expenses. First, Staff proposes to reduce Sydnor's rate case expense to $20,000 and amortize the balance over a ten-year period.[45] Staff derived that level by adding invoices totaling $11,941 and an additional $8,059 which Staff estimated would be expended to conclude the case.[46] The Company argues that $39,000 should be included as a reasonable level of rate case expenses, and further, that it should be amortized over three years and recovered through a special bimonthly surcharge of $8.50.[47] The Company argues that with a surcharge it can temporarily adjust its rates to recover the additional cost of regulation without affecting the 1963 contract.[48]

Staff argues that the Company's proposal would result in rate shock.[49] Staff further asserts it only disallowed a portion of the expense which was estimated. Moreover, Staff sought additional documentation of actual expenses, but the Company did not produce it.[50] Finally, Staff testified that

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[43]Brief at 40.

[44]Ex. MRDB-10, at 2-5; Tr. 82-83.

[45]Ex. MRDB-9, at 14.

[46]Tr. 83, 132.

[47]Ex. BCD-3, at 5; Tr. 44.

[48]Ex. BCD-4, at 3-4.

[49]Ex. MRDB-9, at 14.

the percentage of Sydnor's proposed rate case expense relative to its adjusted annual test year revenues is approximately 48% of adjusted annual test year revenues.[51] That level is unreasonably high in Staff's opinion.

Unlike the "typical" case initiated by a regulated utility, the Company argues that this case justifies higher rate case expenses because the Company was compelled to incur the expenses to defend itself from its customers' complaints and the Commission's exercise of jurisdiction. Since this is the first case in which the Commission has asserted jurisdiction over the First Colony system, the Company argues that it raises numerous unique and difficult jurisdictional issues that required Sydnor to file more responsive pleadings than usual.[52] The Company also asserts that its 1963 contract did not contemplate or provide for recovery of costs associated with the added regulatory and accounting requirements imposed by the Commission in this case.[53] The Company's estimate included legal work for a number of services provided prior to the hearing, appearance at a one day hearing, preparation of a post-hearing brief, and comments on the report of the hearing examiner.[54]

The Company is quick to observe that the Staff has accepted greater levels of rate case expenses for other companies.[55] It refers specifically to Lake Monticello which was allowed rate case expenses totaling $32,439.[56] However, that company has annual revenues in excess of $1,000,000, and thus its allowed rate case expense represented only approximately 3% of its adjusted annual test year revenues.[57]

The Virginia Supreme Court has found that disallowance of rate case expenses was reasonable where there was evidence that such expense was "exorbitant, unnecessary, wasteful, or extravagant."[58] In *Lake of the Woods* the Virginia Supreme Court affirmed the Commission's decision to decline to allow the utility to pass along "whatever a company might choose to spend for legal and accounting assistance in connection with a rate case."[59] Moreover, and importantly, in the pending case, Staff does not propose to disallow any actual expenses and only a portion of the estimated expense. I find Staff's level of rate case expenses to be reasonable.

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[50]Tr. 91, 132.

[51]Tr. 83, 106.

[52]Ex. BCD-4 at 4-5.

[53]Ex. BCD-4, at 3-4.

[54]Id. at 6.

[55]Ex. BCD-4, at 5*; Application of Lake Monticello Service Company*, Case No. PUE960064, 1997 S.C.C. Ann. Rep. __ (September 3, 1997 Final Order).

[56]Id.

[57]Tr. 47.

[58]*Lake of the Woods Utility Company v. State Corporation Commission*, 223 Va. 100, 110 (1982).

[59]*Application of Lake of the Woods Utility Company*, Case No. PUE800081, 1981 S.C.C. Ann. Rep. 169, 176.

The Company and Staff also disagree on a reasonable amortization period. Staff's ten-year amortization period was recommended due to the materiality of the rate case expense.[60] Further, Staff witness DeBruhl testified that since Sydnor had never been before the Commission for regulation of its rates, a ten-year period was not only "appropriate, [but might even] be conservative."[61] The Company supports a shorter amortization period, and argues that if a longer period is used it should be allowed a return on the balance.[62] The Company asserts that the amortization period should correspond to the period the rates are expected to be in effect. In this case, the Staff recommends that the Commission retain jurisdiction for two years so the Company argues that it can be anticipated that rates will remain in effect for two years. It notes, however, that it seeks an amortization period of three years. It also argues that Staff can cite no other case in which it has proposed or the Commission has approved a ten-year amortization period for rate case expenses.

Here, Sydnor is unregulated in the traditional sense, therefore it is reasonable to expect an extended period between regulatory cases thus supporting an amortization period longer than typical. The Commission has amortized rate case expenses over varying periods considering the expected period between cases and the magnitude of the expense. The nature of the proceeding now pending before the Commission warrants a longer amortization period, but Staff's proposed ten-year amortization is unprecedented. I recommend that rate case expenses of $20,000 be amortized over a five-year period. Moreover, there is no precedent for allowing a return on the balance.[63] It therefore is not appropriate to allow a return on the balance.

Finally, Staff and the Company disagree on the mechanism for recovery of rate case expenses. Staff opposes the proposed use of a surcharge. Surcharges, Staff argues, are inconsistent with sound ratemaking principles. Staff also argues that it has included sufficient revenue to allow the Company to recover a reasonable level of its costs, and hence, the record does not support establishing surcharges.[64] Staff argues that the Company should not be allowed an adjustment which is analogous to an automatic adjustment clause or similar to the Commission's previous treatment for deferred capacity. Staff asserts that the Company controls how much it spends on litigation, the costs are neither volatile nor continuous. Rate case expenses thus do not meet the criteria for the establishment of a surcharge or an automatic adjustment clause. The Company asserts it is necessary to recover costs it would not otherwise incur. The Company argues that Staff proposes to impose additional burdens on the Company by imposing regulation, but deny it recovery of the costs of such burdens. Staff witness DeBruhl countered that the Company had sufficient revenues to recover the additional costs.[65]

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[60]Tr. 84.

[61]Id.

[62]Tr. 110.

[63]Tr. 111.

[64]Id.

[65]Tr. 114.

I agree with the Staff. The circumstances here do not warrant the extraordinary relief that surcharges or other automatic adjustment clauses offer. The nature of such clauses is well settled in Virginia law.[66] The Virginia Supreme Court has affirmed the Commission's conclusion that an automatic adjustment clause "is a privilege which may be granted by a regulatory commission at its discretion; it is not a right to which the utility is entitled."[67] The purpose of an automatic clause is to allow a utility to adjust without a rate proceeding its revenues in response to changes in the cost of a relatively volatile, major expense item which the utility incurs on a continuous basis and over which it has little control.[68]

The rate case expenses at issue in the pending case are not volatile or continuous, and hence, do not satisfy the standard for awarding a special surcharge. Moreover, the record herein supports the conclusion that the Company's revenues are sufficient to recover the additional costs of this case and continuing regulation.

b. Tracking and Reporting Expenses

The Company proposes a second bimonthly surcharge of $5.06 to permit Sydnor to collect the costs related to tracking and reporting First Colony system's revenues and expenses. Sydnor historically has maintained the books for its many unregulated water systems on an aggregated basis and therefore has not kept the revenues and expenses of the First Colony system separately. Moreover, Sydnor has not been required to maintain those books and records on the basis of the Uniform System of Accounts.[69] The Company asserts that its controller, Mr. Marusco, developed a cost accounting system to specifically track the costs of the First Colony system for this case. He kept track of the time exclusively devoted to developing that system, tracking the expenses, and preparing system financial reports.[70] The proposed surcharge is based on those directly assigned costs of the Company's controller[71] Again, the Company asserts that a surcharge allows it to recover expenses that were not built into the rates established by the 1963 contract. For this surcharge the Company proposes an amortization period that matches the period of time over which the Commission retains jurisdiction.[72]

Staff disallowed that direct assignment. Staff's adjustment reduced the Company's salary expense by $2,029.[73] Staff, however, agreed with the allocation of a portion of Mr. Marusco's annual salary to the First Colony system.[74] Staff asserts that preparation of the financial reports for

[66] *Old Dominion Power Company, Inc. v. State Corporation of Virginia*, 228 Va. 528 (1984).

[67] *Application of Old Dominion Power Company, Inc.*, Case No. PUE830035, 1984 S.C.C. Ann. Rep. 408, 409.

[68] Id.

[69] Tr. 111-112.

[70] Ex. BCD-4, at 6.

[71] Ex. BCD-4, at 7.

[72] Id.

[73] Ex. MRDB-9, at 6; Tr. 120.

[74] Ex. MRDB-9, at 5.

the First Colony system is nonrecurring.[75] Moreover, Staff argues that the work performed by the controller did not result in an incremental cost since his salary was the same regardless of whether he is performing services for the First Colony system, one of the other systems, or another Sydnor business.[76] Staff testified that either the salary cost should be allocated or costs should be directly assigned. Staff asserts that a combination of the two, as proposed by the Company, results in an accounting mismatch.[77]

Mr. Dooley responded that water company employees often charge their time directly when they are working for a specific company but allocate work done of a general nature.[78] The Company also asserts that absent this proceeding, the costs in question would never have been incurred. Further, it alleges that the costs of tracking system expenses will continue as long as the Commission continues to exercise jurisdiction. The Company finally argues that disallowing those costs would encourage companies to have the work done externally rather than to take advantage of the economic efficiencies of having the work done internally.

Again, I agree with Staff. If all of Mr. Marusco's salary is allocated among the many operating systems, and even a portion of his salary costs are directly assigned, it is evident that at least a portion of his salary would be accounted for twice. Thus in this case his salary expense should be allocated, but no additional salary costs should be included. Certainly it would be possible to allocate only a portion of an employee's salary, for example 80%, if it was determined that such a portion of the time was spent on general matters. The remaining 20% could then be directly assigned to various specific projects without resulting in double accounting. The utility, however, carries the burden of the requisite recordkeeping, and Sydnor did not offer any such evidence.

Moreover, even if additional salary costs for the development, tracking and reporting of First Colony system costs are deemed to be proper by the Commission, the proposed surcharge should not be approved for the same reasons a rate case expense surcharge is inappropriate and as discussed above.

c. Additional Salary Expense

In rebuttal, Company witness Dooley challenged Staff's adjustment to vacation and holiday pay expense.[79] Staff subsequently included a level of vacation and holiday expense for hourly employees in supplemental testimony filed on November 11, 1997; however, Mr. DeBruhl did not include any additional expense for salaried employees since those expenses are already included in salaried compensation, and therefore, there is no additional liability imposed of the Company.[80] The Company did not argue this issue further on brief. I find Staff's adjustment to be reasonable.

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[75] Id. at 6.

[76] Id.

[77] Tr. 95, 121-122.

[78] Ex. BCD-4, at 6; Tr. 139.

[79] Ex. BCD-4, at 7.

[80] Ex. MRDB-10, at 2.

d. Leak Repair

The Staff annualized the leak repair expense incurred during the six-month test period. Staff reduced the Company's adjustment for leak repair by $2,487.[81] Staff witness Stevens testified that corrective action taken by the Company reduced the frequency of leaks on the system prospectively.[82]

The Company's adjustment for leak repair expense is based on historical data that supported a higher number of leak repairs.[83] The Company adjusted the cost of service for the First Colony system to normalize the test period expense and bring the expense component for repairing leaks up to an average level that has been incurred in recent years. The Company argued that it experienced a lower than average level of system leaks during the six-month test period. The Company asserts that the Staff selectively and inconsistently annualizes those expenses that result in a lower cost of service and declines to annualize others.

Although the Company's efforts to reduce the incidents of leaks to which Mr. Stevens testified, exhibit reasonable and prudent operations and maintenance, its effects on the costs of repairing leaks cannot be ignored. The record shows that those costs are lower, therefore I find Staff's adjustment to annualize the test period costs is reasonable as it is the most current indication of those costs going forward.

e. Uncollectible Expense

The Company proposes to include a 1% allowance for bad debts.[84] Staff removed $754 and included no allowance. Staff testified that its policy is to include the level of uncollectible expense actually incurred during the test period, subject to a ceiling of 1%.[85] Since the First Colony system incurred no bad debt during the test period, the Staff concluded that it should not be allowed to recover for an expense it does not incur.[86] The Company argues that there are no guarantees that it will continue to collect all of its billed revenues from its customers. It asserts that denying it a bad debt allowance would penalize it for efficient collection practices.[87] The Company argues that some level of reserve for bad debt expense is consistent with Generally Accepted Accounting Principles. Mr. Dooley admits, however, that the reserve account should be reviewed for reasonableness.[88]

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[81]Ex. MRDB-9, at 11 and Schedule A.

[82]Tr. 73.

[83]Exs. BCD-3 at 6; BCD-4, at 12.

[84]Ex. BCD-3, at 7.

[85]Ex. MRDB-9, at 12, Tr. 43, 92.

[86]Ex. MRDB-9, at 12.

[87]Ex. BCD-4, at 12.

[88]Tr. 62.

A reasonable level of uncollectible expense for Sydnor is zero. I agree that a company should not be penalized for efficient billing practices, but similarly the customers should not be penalized for timely payment of their bills. Since there is no evidence of a collection problem, there is no basis for allowing an uncollectible expense. Staff's adjustment is reasonable.

f. Meter Expense

Staff disallowed $371 of meter expense associated with replacing water meters.[89] Staff instead capitalized those costs consistent with the Uniform System of Accounts for Class C Water Companies.[90] In rebuttal, Company witness Dooley argued that the activities to replace meters due to leaks or inaccurate readings were part of ongoing maintenance operations. He thus expensed and annualized the test period.[91] The Company, however, did not continue to take issue with Staff's adjustment on brief. I find the costs of replacing meters should be capitalized.

[89]Ex. MRDB-9, Ex. VI; Tr. 89.

[90]Tr. 50, 85, 89.

[91]Ex. BCD-4, at 8.

g. Miscellaneous Expenses

Several other expenses remained in controversy. For some of those items, Staff declined to annualize the expense level incurred in the six-month test period because Staff considered the expenses to be nonrecurring or determined the annual level was incurred during the short test period. Staff further asserts that the Company presented no evidence to support higher levels and if allowed an annualized effect, the Company would double recover those expenses.[92] The Company asserts that Staff has understated the expenses.[93]

First, the Company argues that an additional $2,118 should be included for legal other than rate case expenses.[94] That amount included several additional invoices that Staff had not included. Sydnor also annualized the test period level of expenses. In supplemental testimony, Staff made some revision to legal expenses to include a July 1997 invoice. Other invoices offered by the Company however, were not for services related to providing water service.[95] Also in that supplemental testimony Staff annualized the Company's legal fees. Legal expenses, other than for the rate case are ongoing throughout the year and should be annualized. Since Staff's supplemental adjustment corrected the test period expense level and annualized it, Staff's adjustment should be adopted.

The test period level of dues and professional fees should also be annualized. The Company asserts that dues are incurred throughout the year.[96] Mr. Royall specifically identified several professional organizations for which dues are billed in the second half of the year.[97] I find that it is reasonable to annualize the Staff's test period miscellaneous fees.[98] Those annualized fees allocated to the First Colony system would be $20.

The Company next alleged that Staff omitted $307 of depreciation expense for office equipment. The record reveals that depreciation expense was omitted, thus it is reasonable to adjust cost of service to include that expense.[99]

The Company also argues that annualizing the six-month level of paint and gravel expense would allow the Company to recover a reasonable ongoing annual level of materials and supplies expenses.[100] Although the Company puts gravel down around the buildings and on access roads

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[92]Ex. MRDB-9, at 5.

[93]Ex. BCD-4, at 9-12.

[94]Ex. BCD-4, at 11, Tr. 59-60, 90.

[95]Ex. MRDB-10, at 4.

[96]Ex. BCD-4, at 10.

[97]Tr. 68.

[98]Ex. MRDB-9, VIII, at 6.

[99]Tr. 91.

[100]Ex. BCD-4, at 9.

every two or three years,[101] I agree with the Company that an annualized allowance for materials and supply expense is proper.

Finally, Staff asserts there is no evidence to support the additional roof repair expense of $31.[102] It is Staff's understanding that the expense is incurred about once a year.[103] Therefore, Staff's adjustment is reasonable

h. Revenue Requirement

Considering all adjustments discussed above, I find that the Company's gross annual revenue requirement for the First Colony system is $78,995. That level of revenue would provide net income of $3,949, or approximately 5% of total revenues.

3. Toll Free Calling

Staff witness Stevens proposed that the Company be required to implement toll free calling for service problems. While the Company did not oppose that recommendation, it did complain that the additional cost of such service was not included in the Staff's calculation of the Company's cost of service although Staff witness Stevens agreed that such cost would be an allowable expense.[104] Mr. DeBruhl, however, pointed out that the cost information had been requested of the Company, but not provided by the time of the hearing.[105]

Staff's recommendation is appropriate and should be adopted. Toll free calling for service problems should also help the Company to be more responsive to some of the concerns expressed by Mr. Hudgins, Mr. Haltiner and Mr. Hewett. There is no evidence, however, to support an adjustment to cost of service for implementation of toll free calling.

4. Implementation of Continuing Jurisdiction

Finally, Staff recommends that the Commission continue to exercise jurisdiction over the Company for two years from the date of a final order herein. The service concerns expressed by the public witnesses also could be monitored by continuing jurisdiction for some time period. It should be noted that Staff does not suggest that the Company must continue separately tracking or reporting First Colony system revenues and expenses.

I support Staff's recommendation and also recommend the Commission retain jurisdiction to monitor the Company's service.

If jurisdiction is exercised, the Company asserts that the 1963 contract will be filed as its tariff and rate schedule and that it provides for periodic rate increases in accordance with the cost of

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[101]Tr. 89.

[102]Ex. MRDB-10, at 4.

[103]Tr. 88.

[104]Tr. 75.

[105]Tr. 83.

living escalator. Therefore, the Company plans to increase its rates pursuant to rate adjustment provisions in paragraph 8 of the contract.[106] Sydnor argues that its rates should not be frozen.

Staff asserts that if the Commission retains jurisdiction over the Company it may not unilaterally increase its rates pursuant to the contract.[107] I agree. Section 13.1-620 G provides in pertinent part:

> Upon ordering into effect any rate changes or improvements found to be just and reasonable, the water or sewer system shall remain subject to the Commission's regulatory authority in the same manner as a public utility for such reasonable period as the Commission may direct.

Accordingly, Sydnor shall remain subject to Commission jurisdiction in the same manner as a public utility. Just as any regulated utility cannot raise its rates without Commission approval, Sydnor would have to seek Commission approval under the procedures set forth in Chapter 10, Title 56 of the Virginia Code. If it seeks such an increase, it, of course, will need to segregate First Colony data to support its application.

FINDINGS AND RECOMMENDATIONS

In conclusion, based on the evidence received in this case, I find that:

1. The use of a six-month test period ending June 30, 1997, is proper in this proceeding;

2. The Company's annual operating revenues, for the First Colony system, after all adjustments, were $82,995;

3. The Company's annual operating revenue deductions for the First Colony system, after all adjustments, were $76,564;

4. The Company's net operating income for the First Colony system, after all adjustments, was $6,431;

5. The Company's current rates produce a return on adjusted rate base of 40.70%;

6. The Company's First Colony system adjusted rate base is $15,802;

7. The Company's current rates are unjust and unreasonable because they will produce revenue which would generate a return on rate base of 40.70%;

8. The Company requires $78,995 in gross annual revenues to earn a 24.99% return on rate base;

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[106]Company Brief at 42-43.

[107]Tr. 117-119; Staff Brief at 30.

9. The Company should be required to refund, with interest, all revenues collected under its interim rates in excess of the amount found just and reasonable herein;

10. The Company shall maintain a detailed record of service interruptions, including the date, the location and a brief description of the interruption;

11. The Company shall implement toll free calling for after business hours service problems; and

12. The Commission should retain jurisdiction over Sydnor for two years from the date of the final order herein.

In accordance with the above findings, ***I RECOMMEND*** that the Commission enter an order that:

1. ***ADOPTS*** the findings in this Report;

2. ***REDUCES*** the Company's rates as described above; and

3. ***DIRECTS*** the refund of all amounts collected under interim rates in excess of the rate increase found just and reasonable herein.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P. O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all other counsel of record and to any party not represented by counsel.

Respectfully submitted,

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Deborah V. Ellenberg
Chief Hearing Examiner